

**The Internal Revenue Service Needs to
Simplify Filing Requirements and Clarify
Processing Procedures for Small Business
Corporate Returns**

September 2002

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 23, 2002

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Acting Inspector General

SUBJECT: Final Audit Report - The Internal Revenue Service Needs to
Simplify Filing Requirements and Clarify Processing Procedures
for Small Business Corporate Returns (Audit #200130037)

This report presents the results of our review of the processing of small business corporate returns. The overall objective of this review was to evaluate the effectiveness and efficiency of the Internal Revenue Service's (IRS) policies and procedures established for the filing and processing of small business corporate returns. We particularly focused on the ability of first-time filers to timely and easily file their small business corporate returns.

In summary, the processing of small business corporate returns needs to be simplified to better enable small businesses to successfully file their U.S. Income Tax Return for an S Corporation (Forms 1120S). Currently, taxpayers and the IRS have to take many steps before the returns of first-time filers can be processed to their accounts. Each year an estimated 46,000 small businesses are not successful in filing Forms 1120S because the IRS does not have valid elections on file to allow their returns to be processed. These taxpayers spend an estimated 3.2 million hours each year preparing, copying, assembling, and sending these returns to the IRS, which could then not successfully process them.

In addition, the IRS did not consistently process Forms 1120S and determine the correct taxes due from small business taxpayers. Each year, the IRS does not process an estimated 9,000 returns as small business corporations, even after the taxpayers verify that their election requests were granted. Instead, the IRS converts and processes these Forms 1120S as regular corporate returns without considering the fact that the taxpayers verified the elections were granted. Because these returns were not processed correctly, there is the potential for the erroneous assessment of taxes on

\$41.0 million of profits and the inability of taxpayers to claim \$100.3 million in losses. Furthermore, because of unclear IRS procedures, approximately 3,700 taxpayers who file unprocessable Forms 1120S may have their rights violated when the IRS assesses taxes on an estimated \$6.7 million in profits without sending a statutory notice of deficiency. A statutory notice of deficiency allows the taxpayer to respond to the proposed assessment before taxes are actually assessed.

We recommended that the IRS determine if there are alternatives, including possible modification of the legal requirements, that could be implemented to make it easier for first-time filers to be granted elections and file their Forms 1120S. We also recommended that procedures be developed that would improve and simplify both the process for approving, recording, and controlling elections and the related notification process. In addition, we recommended procedures be clarified for preparing and assessing taxes on Forms 1120S and for issuing statutory notices of deficiency.

Management's response was due September 16, 2002. As of September 18, 2002, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Background

Entities that wish the Internal Revenue Service (IRS) to consider them small business corporations so they can file a U.S. Income Tax Return for an S Corporation (Form 1120S) must first file an Election by a Small Business Corporation (Form 2553).¹ According to the IRS, S Corporations, also known as small business corporations, represent more than one-half of all corporate entities filing tax returns.

The major advantages of filing as a small business corporation are, generally, that the small business pays no corporate tax, and that profits or losses are passed through to the shareholders to be reported on their individual income tax returns. In contrast, a regular corporation that files a U.S. Corporation Income Tax Return (Form 1120) pays corporate tax on its profits, and its shareholders cannot claim corporate losses on their individual returns.

This audit was conducted from December 2001 through June 2002 at the Small Business/Self-Employed (SB/SE) Division's Headquarters Office and the Brookhaven IRS Campus and included a review of transactions for all 10 IRS Campuses. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Legal Requirements and the Internal Revenue Service's Burdensome Process Are Hampering First-Time Filers from Successfully Filing Their Small Business Corporate Returns

First-time filers of Forms 1120S encounter an IRS processing system that is not as effective as it should be. The legal requirements to file an election in conjunction with the IRS' burdensome practices for filing Forms 1120S have created a situation in which many first-time filers are unable to easily file their Forms 1120S because they do not have a valid election on file.

Also, there appears to be a significant difference between the number of taxpayers who are granted elections and the number of small businesses who actually have their small business corporate returns processed to their tax accounts. Over a 3-year period, the increase in filings of Forms 1120S

¹ Internal Revenue Code, 26 U.S.C. §§ 1362 (a) and (b) (1994).

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(over 437,000)² was not commensurate with the number of taxpayers who were informed that their elections were granted (about 1.2 million).

In May 2000, the IRS Commissioner testified to the Senate Committee on Small Business that one of the IRS' most basic goals is to help, to the best of its ability, small businesses understand their tax obligations and reduce their burden. Further, the IRS has the authority and responsibility to improve the way the whole tax system works for small business taxpayers, including preventing problems before they occur and reducing administrative burden.³

Factors hampering first-time filers from filing Forms 1120S

The following factors have caused this problem for first-time filers of Forms 1120S.

Notification process - It appears from our analyses that the IRS did not always notify taxpayers that their elections were granted or denied. As previously mentioned, there is a legal requirement in the Internal Revenue Code that first-time filers of Forms 1120S must file an election to be treated as a small business corporation. During CYs 1998, 1999, and 2000, almost 1.5 million taxpayers filed elections,⁴ and about 1.2 million⁵ were granted. However, for the remaining 300,000 taxpayers, fewer than 4,700 were sent notices that their elections were denied. We found no evidence that the other 295,300 taxpayers received notification from the IRS that their elections were either accepted or denied.

² IRS records indicate that the volume of filings of Forms 1120S from 1997 through 2000 were as follows: Calendar Year (CY) 1997 – 2,449,900; CY 1998 – 2,599,800; CY 1999 – 2,767,000; and CY 2000 – 2,887,100. The total increase in filings of Forms 1120S over the last 3 years was 437,200 (an increase of 149,900 in CY 1998; 167,200 in CY 1999; and 120,100 in CY 2000).

³ *Prepared Testimony of the Commissioner of the IRS Before the Senate Committee on Small Business: Improving Service to Small Businesses*, May 23, 2000.

⁴ CY 1998 – 484,281; CY 1999 – 494,557; and CY 2000 – 508,122.

⁵ CY 1998 – 395,881; CY 1999 – 389,713; and CY 2000 – 405,880.

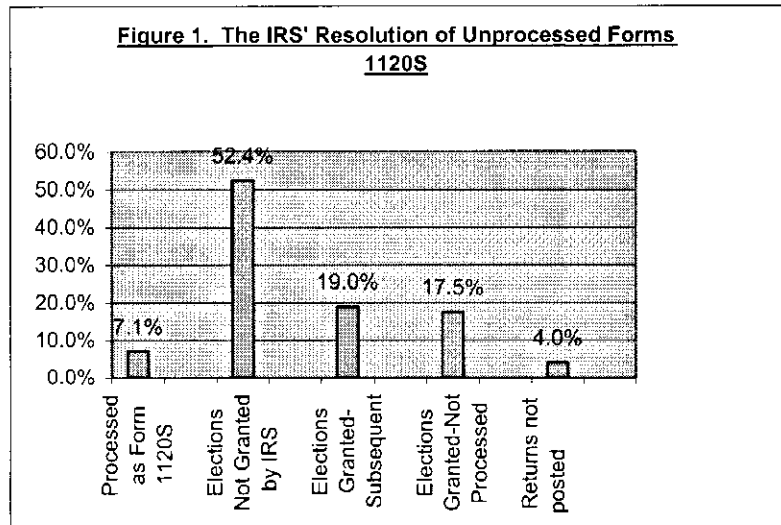
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Cumbersome verification process - The IRS has a cumbersome verification process for unprocessable Forms 1120S that requires it to request verification from taxpayers showing that their elections were granted, wait for their responses, and then resolve the unprocessable Forms 1120S (see Appendix V for details). Over the 3-year period, the IRS had a recurring problem with thousands of first-time filers who filed Forms 1120S, while the IRS did not have valid elections on file to allow their returns to be processed. Although the IRS attempted to contact these taxpayers to have them verify that their elections were granted or to have them file Forms 1120, many returns were not processed to the taxpayers' accounts as Forms 1120S.

Our review of a statistically valid sample of 269 initially unprocessable Forms 1120S⁶ showed that the IRS was able to resolve and successfully process only 7.1 percent of the returns as Forms 1120S (see Figure 1). The remaining 92.9 percent were not successfully processed as Forms 1120S because elections were not granted, elections were granted only for subsequent tax periods, or the IRS subsequently verified that elections were granted to file the Form 1120S but still did not process the returns as Forms 1120S.

⁶ We selected 269 of 50,038 unprocessable small business corporate returns for CY 2000 with certain criteria that primarily related to Forms 1120S.

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Source: Treasury Inspector General for Tax Administration review of statistical sample of unprocessed Forms 1120S.

Weak controls and unclear procedures - The IRS did not have good controls or procedures in place to ensure that Forms 1120S were processed even when taxpayers verified that they were granted elections.

The IRS has recognized that the unique requirements for submitting elections to become Form 1120S filers and the related approval process have caused a large number of returns to be filed but not processed as Forms 1120S. The IRS indicated that the major issue involves the taxpayers' misunderstanding of the requirements for preparing and filing Forms 2553 and Forms 1120S. The IRS reviewed the related instructions for these forms and the acceptance letter and indicated that they were generally confusing and vague. The IRS' ongoing efforts to reduce taxpayer burden include plans to revise instructions and make changes to the acceptance letter and the election form. Also, proposed recommendations regarding future enhancements to the electronic filing of corporate returns include adding a check to ensure that there are valid elections on file before accepting the Forms 1120S. Finally, the consolidation of the processing of small business corporate returns from 10 IRS campuses to 2 IRS campuses was fully completed in CY 2002.

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However, the IRS has not yet reduced or simplified the current Form 1120S filing and processing requirements for these small business taxpayers.

Effects of the current Form 1120S filing and processing requirements

We estimate that, each year, over 46,000 small businesses are unsuccessful in filing their Forms 1120S because the IRS does not have valid elections on file to allow their returns to be processed. Although we were unable to quantify actual burden costs, we estimate that taxpayers spend 3.2 million hours each year to prepare, copy, assemble, and send these returns to the IRS, which could not successfully process them. Also, it costs the IRS an estimated \$264,000⁷ annually to handle the Forms 1120S that could not be processed.

Taxpayers and the IRS need to perform too many steps before Forms 1120S can be successfully processed for first-time filers. These steps are time consuming and burdensome for the IRS and especially for first-time filers who are not familiar with all of the necessary steps. If the IRS continues with its current policies for the filing and recording of elections, many first-time filers of Forms 1120S will continue to be unsuccessful in filing their returns.

Recommendations

1. The Director, Compliance, SB/SE Division, should simplify the process of filing election forms and Forms 1120S for new filers by determining if there are alternatives to make it easier for first-time filers to be granted elections and file their Forms 1120S, and by considering implementing alternatives and seeking modification of the legal requirements, as necessary.
2. The Directors of Customer Account Services and Compliance, SB/SE Division, should develop procedures that would improve and simplify both the

⁷ This total does not include the cost of the IRS' attempts to resolve the unprocessable conditions.

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process for approving, recording, and controlling elections and the related notification process to make it easier for taxpayers to file their Forms 1120S.

Management's Response: Management's response was due September 16, 2002. As of September 18, 2002, management had not responded to the draft report.

The Internal Revenue Service Did Not Consistently Determine the Correct and Proper Taxes Due by Small Business Corporate Taxpayers

The IRS did not consistently process Forms 1120S and determine the correct taxes due from small business corporate taxpayers. The IRS did not always process returns as Forms 1120S, even when taxpayers verified that their election requests were granted. The IRS also did not consistently assess taxes on or record losses from Forms 1120S that taxpayers filed without the required elections being on file.

The IRS has the authority and responsibility for providing procedures and consistently applying them to determine the correct and proper taxes that are due by corporate taxpayers. In addition, the General Accounting Office's *Standards for Internal Controls in the Federal Government* state that internal controls should provide reasonable assurance that the effectiveness and efficiency of operations are achieved. The *Standards* also state that internal controls, all transactions, and other significant events need to be clearly documented and that application controls ensure completeness, accuracy, and validity of all transactions.

The primary cause for the inconsistent processing of Forms 1120S and the inconsistent determinations of taxes is the absence of clear and complete IRS guidelines. The unclear and incomplete guidelines relate to the handling of Forms 1120S that could not be processed because the IRS had no record that elections had been granted. Guidelines that are unclear and incomplete can lead to inconsistent actions.

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The IRS did not always process returns as small business corporate returns once it verified that elections were granted to file these returns

When the IRS cannot process a Form 1120S because there is no record of the required election being granted, the Form 1120S is generally converted to a regular Form 1120 and recorded in the taxpayer's account as such. If the IRS subsequently verifies that the taxpayer's election was granted, the taxpayer's account should be adjusted to accurately reflect the filing of a Form 1120S.

The IRS did not process an estimated 9,000 returns as Forms 1120S in CY 2000, even though the taxpayers verified that their election requests were granted. In general, once Forms 1120S were converted to Forms 1120, they were not converted back to Forms 1120S in taxpayers' accounts when the IRS received confirmation of the approved elections.

There were no indications that the IRS had established procedures to ensure that their records accurately reflected the filing of Forms 1120S once the IRS subsequently verified that elections were granted. Also, the IRS had no specific procedures for converting a Form 1120 back to the originally intended Form 1120S.

In 47 (17.5 percent) of our 269 sample cases, the IRS granted elections for the tax years filed after researching records and contacting the taxpayers but did not process the returns as Forms 1120S. For these 47 cases:

- Profits totaling approximately \$220,000 were reported in 15 cases and taxes of \$20,000 were erroneously assessed because tax returns were not correctly processed as Forms 1120S.
- Losses were reported in 21 cases totaling approximately \$538,000. Because these returns were not correctly processed as Forms 1120S, shareholders would not be entitled to claim these losses on their individual income tax returns.
- No taxes were reported in 3 cases.

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- IRS records were not available in 8 cases to indicate whether profits or losses were reported.

As a result, taxpayers were treated inconsistently and tax information in the IRS' files was incorrect and incomplete. In addition, based on the results of our sample, we estimate that, each year, there is the potential for taxes on profits of \$41.0 million to be erroneously assessed to taxpayers who actually have valid elections on file. There is also the potential for losses of \$100.3 million to be erroneously reflected on Forms 1120 and for shareholders to not be allowed to claim these losses.⁸

The IRS did not consistently assess taxes on profits or record losses from small business corporate returns filed without required elections

The problems of the IRS not determining correct taxes due and consistently recording related profits and losses in tax accounts also occurred when the IRS could not verify that there were elections on file. The IRS could not resolve or accept the filing of small business corporate returns as Forms 1120S in CY 2000 for approximately 36,000⁹ taxpayers because elections were either granted for subsequent years or not granted at all.

On May 20, 1999, IRS District Counsel advised the Philadelphia IRS Campus that the IRS could prepare Forms 1120 from incorrectly filed Forms 1120S that could not be resolved through contacts with the taxpayer. Counsel indicated incorrect returns that provide sufficient data to calculate tax liabilities constitute returns but stipulated that the IRS must first issue statutory notices of deficiency before assessing taxes. A statutory notice of deficiency is a notice that allows the taxpayer to respond to the proposed assessment before taxes are actually assessed.

⁸ The dollar figures reported are projections in relation to the 9,000 taxpayers.

⁹ The estimate is based on the results of our review of a statistical sample of 269 cases and is projected for the population of 50,038 cases. Against the population, we applied the percentage of cases, 71.4 percent (192/269), in which Forms 1120S could not be filed because elections were either granted for subsequent years or not granted (71.4 percent of 50,038 is 35,727 taxpayers).

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However, the IRS used inconsistent practices in the assessment of corporate taxes, as follows.

- In 95 (35.3 percent) of our statistical sample of 269 cases,¹⁰ unprocessable Forms 1120S were converted to Forms 1120 without being sent to the Classification function,¹¹ as required. The IRS generally processed the Forms 1120 and assessed any resulting tax liability but did not send required statutory notices of deficiency.
- In 128 (47.6 percent) of our sample cases, unprocessable Forms 1120S were converted to Forms 1120 and forwarded to the Classification function. However, the Classification function either accepted these cases as filed or sent them to the Examination function that decided not to examine these returns. Therefore, some Forms 1120 were recorded in tax accounts, but taxable income or losses were generally not recorded and potential taxes were not assessed on the profits where required.
- The remaining 46 cases (17.1 percent) consisted of 19 that were processed as Forms 1120S, 16 in which the taxpayers filed Forms 1120 and had no valid election, and 11 in which returns were not posted.

The IRS guidelines were unclear and incomplete. There were no specific instructions for screening Forms 1120 that resulted from unprocessable Forms 1120S and no instructions for the treatment of profits and losses. Primarily, the guidelines instructed the Classification function to follow the procedures for identifying examination issues on Forms 1120. The IRS guidelines did not provide instructions for computing the correct taxes on corporate profits, sending required statutory notices of

¹⁰ The 95 cases involved 29 reporting profits, 47 reporting losses, and 19 showing zero balances.

¹¹ Classification is the process of determining whether a return should be selected for examination, what issues should be examined, and how the examination should be conducted.

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deficiency, or recording losses for Forms 1120S that were converted to Forms 1120.

The inconsistent handling of the profits and losses from Forms 1120S leads to violations of taxpayer rights, creates the potential for lost revenue, hampers the IRS' compliance efforts, and creates unnecessary taxpayer burden, as follows.

Potential taxpayer rights violated - About 3,700 taxpayers¹² may have had their rights violated because the IRS assessed taxes on estimated profits of \$6.7 million without providing taxpayers with statutory notices of deficiency.

In 20 (7.4 percent) of the 269 cases we reviewed, Forms 1120S were converted to Forms 1120 and were assessed approximately \$36,000 in taxes without indications of statutory notices of deficiency being sent to the taxpayers. The IRS made assessments without providing taxpayers with the opportunity to agree, disagree, and/or appeal the decisions.

Potential lost revenue - Tax revenue may be lost because profits from unprocessable Forms 1120S were not always assessed. Also, losses from unprocessable Forms 1120S that were converted to Forms 1120 could result in lost revenue to the IRS. Losses from these Forms 1120 would not be allowed to the shareholders on their individual income tax returns. The fact that most of the Forms 1120 were accepted as filed by the Classification function, combined with the declining IRS examination rate, means that the IRS would likely lose revenue from losses improperly claimed on the shareholders' individual returns.

As previously stated, 128 of the 269 cases in our statistical sample that were sent to Classification involved unprocessable Forms 1120S that were converted to Forms 1120. Of these 128 cases, 28 reported profits totaling approximately \$687,000; 33 reported losses totaling

¹² The estimate is based on the results of our review of a statistical sample of 269 cases and is projected for the population of 50,038 cases. Against the population, we applied the percentage of cases, 7.4 percent (20/269), in which assessments were made without statutory notices of deficiency sent to taxpayers (7.4 percent of 50,038 is 3,703 taxpayers). We used ratios to arrive at the \$6.7 million in tax assessments.

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approximately \$1 million; 6 showed no tax; and tax information/tax returns were not available for the remaining 61 cases. Because of the limited information available, we could not project the amount of lost revenue.

IRS compliance efforts will be hampered - The ability of the IRS to match data on the Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1) from small business corporations to the individual returns, where the taxable income generated by such entities should appear, could be adversely affected. At a conference sponsored by the American Institute of Certified Public Accountants, the IRS Commissioner indicated that one of the significant areas of non-compliance with the tax code is pass-through entities, such as small business corporations.

Unnecessary taxpayer burden - The amount of IRS correspondence with both corporate taxpayers and shareholders would increase in an effort to ensure that an accurate return is on file. Responding to the IRS' correspondence places an unnecessary burden on the taxpayers.

Recommendations

The Director, Compliance, SB/SE Division, should:

3. Establish procedures for ensuring that IRS records accurately reflect the filing of Forms 1120S once the IRS subsequently verifies that an election was granted. Specific procedures should be developed for converting the Forms 1120 back to the originally intended Forms 1120S.
4. Clarify Internal Revenue Manual procedures and assign responsibility for determining and assessing the correct taxes and issuing statutory notices of deficiency for small business corporate returns that could not be processed because the IRS could not verify that valid elections were filed.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the effectiveness and efficiency of the Internal Revenue Service's (IRS) policies and procedures established for the filing and processing of small business corporate returns. We addressed, in particular, the ability of first-time filers to timely and easily file their small business corporate returns. To accomplish this objective, we:

- I. Identified problems and trends related to the effectiveness of the filings of Election by a Small Business Corporation (Forms 2553) and U.S. Income Tax Return for an S Corporation (Forms 1120S). We analyzed statistics for Calendar Years (CY) 1998, 1999, and 2000 regarding Forms 2553, notices sent to taxpayers by the IRS regarding the acceptance or denial of their elections, the volume of Forms 1120S filed, and Forms 1120S that could not be processed to IRS tax accounts (unpostables). We determined whether the IRS had taken actions to simplify the process of submitting, filing, and recording elections to facilitate the filings of Forms 1120S for new filers.
- II. Determined if policies and procedures were established to ensure that the IRS records the correct corporate return for small business taxpayers that may not have valid elections on file. We obtained and reviewed Internal Revenue Manual and other written instructions, met with national and local management officials to obtain information and discuss IRS policies and procedures, and reviewed the Memorandum for District Counsel, Pennsylvania District, from the Assistant Chief Counsel (Field Services) dated May 20, 1999, Subject: Significant Service Center Advice.
- III. Determined if the IRS was efficiently and effectively resolving small business corporate returns that could not be processed to IRS computerized records of tax accounts. We concentrated primarily on instances in which the IRS' records indicated that taxpayers did not reply to required letters used to resolve situations in which Forms 1120S could not be processed.
 - A. Performed a computer extract for each of the 10 IRS Campuses for CY 2000 that represented all 100,773 Unpostable Codes 310. We identified 50,038 out of the 100,773 that were resolved with an Unpostable Resolution Code 8¹ and an Unpostable

¹ The Unpostable Code 310 is generated when the filing requirements of the Forms 1120 or 1120S filed do not match the information on the IRS' computerized files. Unpostable Resolution Code 8 removes the record from the Submission Processing Unpostable Master File.

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Reason Code 2, 4, 5, or 6 (which primarily relate to Forms 1120S). Selected a statistical sample of 269 cases from the above 50,038.

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Clarify Processing Procedures for Small Business Corporate Returns**

Appendix II

Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Richard J. Dagliolo, Director

Robert K. Irish, Audit Manager

Bernard Kelly, Senior Auditor

Michael D. Luongo, Senior Auditor

Philip Peyser, Senior Auditor

Stephen Wybaillie, Auditor

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Appendix III

Report Distribution List

Commissioner N:C
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Deputy Commissioner, Small Business/Self-Employed Division S
Director, Compliance, Small Business/Self-Employed Division S:C
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 Commissioner, Small Business/Self-Employed Division S

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 232,425 taxpayers' accounts affected (see page 5).

Methodology Used to Measure the Reported Benefit:

Selection of Sample -

The Information Technology staff of the Treasury Inspector General for Tax Administration performed a nationwide extract from the Unpostable File (GUF 5702) for Calendar Year 2000 and identified 50,038 unpostable small business corporate returns. The criteria were an Unpostable Code 310 with an Unpostable Resolution Code 8¹ and Unpostable Reason Codes 2, 4, 5, or 6, which primarily relate to U.S. Income Tax Returns for an S Corporation (Form 1120S) that were resolved as “no reply” cases. We used attribute sampling with a 95 percent confidence level, an occurrence rate not over 10 percent, and a precision level of plus or minus 4 percent. We determined that the sample size was 215 cases; however, because it is common for information not to be available for all accounts, we increased our sample size by 25 percent, resulting in a sample of 269 cases.

Sample Results -

We estimate that 46,485 taxpayer accounts would be affected each year if the processing and filing requirements were not revised.

Projection of Sample Results -

232,425 – Business Tax Accounts Affected – The number of business accounts affected was computed using 50,038 unpostable Forms 1120S (per our sample population), less 7.1 percent that were processed to the Internal Revenue Service's (IRS) Master File,² leaving a balance of 46,485. This number was projected over 5 years.

¹ The Unpostable Code 310 is generated when the filing requirements of the U.S. Corporation Income Tax Return (Forms 1120) or Form 1120S filed do not match the information on the IRS' computerized files. Unpostable Reason Code 8 removes the record from the Submission Processing Unpostable Master File.

² The Master File is the main IRS computer system that stores various types of taxpayer account information, including individual, business and employee plans and exempt organizations data.

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Type and Value of Outcome Measure:

- Taxpayer Rights – Potential; the IRS granted elections for the tax years filed after researching IRS records and contacting the taxpayers but did not process the returns as Forms 1120S. We are estimating that 13,965 taxpayers had profits, which were erroneously assessed (see page 7).

Methodology Used to Measure the Reported Benefit:

Selection of Sample -

The same sample referred to earlier was used to determine this outcome.

Sample Results -

In 17.5 percent (47/269) of our sample, the IRS verified that elections were granted for the tax years filed but still did not process the returns as Forms 1120S.

Projection of Sample Results -

13,965 – Business Tax Accounts Affected – Taxpayers with profits (31.9 percent of 8,757) total 2,793. This number was projected over 5 years.

Type and Value of Outcome Measure:

- Taxpayer Rights – Potential; the IRS granted elections for the tax years filed after researching IRS records and contacting the taxpayers but did not process the returns as Forms 1120S. We are estimating that 19,570 taxpayers had losses, which were erroneously reflected on Forms 1120 and shareholders were potentially not allowed to claim these losses (see page 7).

Methodology Used to Measure the Reported Benefit:

Selection of Sample -

The same sample referred to earlier was used to determine this outcome.

Sample Results -

In 17.5 percent (47/269) of our sample, the IRS verified that elections were granted for the tax years filed but did not process the returns as Forms 1120S.

Projection of Sample Results -

19,570 – Business Tax Accounts Affected – Taxpayers with losses (44.7 percent times 8,757) total 3,914. This number was projected over 5 years.

Type and Value of Outcome Measure:

- Taxpayer Rights – Potential; Tax assessments for 18,515 taxpayers without issuing statutory notices of deficiency (see page 10).

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Methodology Used to Measure the Reported Benefit:

Selection of Sample -

The same sample referred to earlier was used to determine this outcome.

Sample Results -

Our review showed that in 7.4 percent (20/269) of the cases we reviewed, Forms 1120S were converted to Forms 1120 and were assessed, without indications of statutory notices of deficiency being sent to the taxpayers.

Projection of Sample Results -

18,515 – Business Tax Accounts Affected – The taxpayers with Forms 1120S that were converted to Forms 1120 and assessed without a statutory notice of deficiency total 3,703 (7.4 percent times 50,038). This number was projected over 5 years.

Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protection – Potential; taxes on profits were not assessed on 28 unprocessable Forms 1120S (see page 8).

Methodology Used to Measure the Reported Benefit:

Selection of Sample -

The same sample referred to earlier was used to determine this outcome.

Sample Results -

In 28 cases, Forms 1120 were recorded on the IRS' Master File of tax accounts, but taxable income and potential tax assessments on profits were not made for the corporations.

Projection of Sample Results -

No projections were made because of the limited information available. We are reporting the outcomes for only the 28 actual cases reviewed.

Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protection – Potential; losses were reported by 33 taxpayers from unprocessable Forms 1120S that were converted to Forms 1120 (see page 8).

Methodology Used to Measure the Reported Benefit:

Selection of Sample -

The same sample referred to earlier was used to determine this outcome.

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Sample Results -

In 33 cases, Forms 1120 involved losses. While losses from these Forms 1120 would not be allowed to the shareholders, since the Forms 1120 were accepted as filed by the Classification³ function in most cases, there is a strong likelihood that the shareholders' returns would not be examined and the IRS would lose revenue from losses improperly claimed on the shareholders' individual returns.

Projection of Sample Results -

No projections were made because of the limited information available. We are reporting the outcomes for only the 33 actual cases reviewed.

³ Classification is the process of determining whether a return should be selected for examination, what issues should be examined, and how the examination should be conducted.

The Internal Revenue Service Needs to Simplify Filing Requirements and Clarify Processing Procedures for Small Business Corporate Returns

Appendix V

How Small Business Corporate Taxpayers File, and How the Internal Revenue Service Processes Small Business Corporate Elections and Tax Returns

The process generally includes the following steps:

- Taxpayers file an Election by a Small Business Corporation (Forms 2553) before filing their initial U.S. Income Tax Return for an S Corporation (Form 1120S).
- The election is processed separately from the initial Form 1120S by the Internal Revenue Service (IRS), given a unique Document Locator Number (DLN),¹ and assigned a unique transaction code. The transaction code is recorded in a separate section of the IRS' computerized record of tax accounts from the section where the tax return is recorded.
- The IRS sends notices to taxpayers to inform them that their elections have been accepted or rejected. If a Form 2553 is incomplete or information is incorrect, the IRS corresponds with the taxpayer to obtain the necessary information and suspends the Form 2553 from further processing while awaiting the taxpayer's response.
- If a taxpayer files a Form 1120S and the IRS has no record of the election on file, the Form 1120S cannot be processed; it becomes what the IRS calls "unpostable." This Form 1120S is transferred from a processing unit to the unpostable unit for research and resolution.
- After preliminary research, if the IRS cannot determine that a valid election is on file, the IRS sends the taxpayer a letter instructing the taxpayer to submit verification that an election was granted (e.g., a copy of the IRS acceptance notice or evidence of approved election) or to file a completed U.S. Corporation Income tax Return (Form 1120).
- The taxpayer has to respond within 30 days with the requested information. If the IRS does not receive a response to the letter, the IRS generally renumbers the Form 1120S to a Form 1120.
- The IRS is then required to send the tax return to the Compliance Services/Classification function for screening.
- The IRS would then have to determine the correct and proper taxes that are due by the corporate taxpayer.

¹ A unique number assigned to every tax return/document to assist in controlling, identifying, and locating documents.